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On Behalf of
THE MICHIGAN INTERNET AND TELECOMMUNICATIONS ALLIANCE
Before the Senate Committee on Energy and Technology
Regarding Review of the Michigan Telecommunications Act

March 15, 2011

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Members of the Committee:

Thank you for taking the time to address an important issue, the establishment of a competitive market in telecommunications in Michigan. At first glance reducing the regulatory power of the Michigan Public Service Commission (MPSC) over the telecommunications industry would seem to move the telecommunications industry towards increased competition. In most industries, this would be the case. However, due to the history of telecommunications and the network effects of the industry, reducing the ability of the MPSC to oversee the wholesale telecommunications market would in fact reduce competition, particularly in the wholesale market for business.

I. Why a Regulatory Authority is Necessary for a Competitive Telecommunications Industry

In most cases, one can argue that government regulation of a company's property is a reduction in property rights. However, the telecommunications industry is an exception. The incumbent companies obtained their infrastructure while protected from competition through government action. These companies were sheltered from risk by government, since government regulators set mandatory charges to customers that covered the cost of the infrastructure along with a guaranteed return on investment -- and their monopoly status ensured that customers could not leave for other companies. The state also mandated local governments and even property owners to provide rights of way for lines at little or no cost to the monopoly. This gave what are now called the Incumbent Local Exchange Carriers (ILECs) the base of the infrastructure that has been added to over the years both by ILECs and by Competitive Local Exchange Carriers (CLECS). So when in attempting to create a competitive market the government required the incumbent monopoly company to provide competitors access to its network, the government was not overriding property rights. It was attempting to eliminate the monopoly over property that it itself had created.[1]

[1] I am reminded of the proverb, "he who lives by the sword shall die by the sword." The incumbent local exchange carrier cannot complain that government is interfering with its infrastructure when it was government action that allowed it to obtain the infrastructure in the first place.

The AT&T (formerly SBC) and Frontier (formerly Verizon) market positions in Michigan are the result of past state and federal decisions determining franchise rights, exclusive service territories, and industry structure. This is significant for two reasons. First, the original monopoly position was unearned and created no rights to monopoly power or control of monopoly-obtained assets once customer choice became possible. Secondly, only the power of government can effectively remove the barriers to entry that government policy created.

Historically, the telephone industry began as a competitive market. Then Theodore Vail, mimicking the process of Samuel Insull in the electric industry, demonstrated that Adam Smith was correct in his famous quote: "People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices."[2] After lobbying the government to grant it a local monopoly over the phone service, the telephone industry became a regulated monopoly, and thereby was able to eliminate the threat of competition and guarantee itself a profitable rate of return. It would be interesting to speculate on how telecommunications would have developed had this strategy not proven successful, and the market had determined the number of phone companies in the various areas of the United States. The point here is that it was the political process that decided that phone service should be a monopoly. Monopolization did not occur due to the emergence of a single seller dominating in an unregulated environment.

To be fair, embracing regulation was only part of a determined strategy by Vail to achieve monopoly of the telecommunications industry. The aggressive use of patents and patent litigation, as well as a merger strategy, led to Bell dominance by the early part of the 20th century. However, the use of the courts and the regulatory agencies were a significant factor in creating the Bell system monopoly.[3]

The state and federal governments have in the last twenty-five years faced the difficult problem of how to move from a regulated monopoly system to a competitive market system. The first point was to require ILECs to provide access to their infrastructure to the CLECs. As the CLECs have built onto the existing ILEC infrastructure, the issue has expanded to how to make sure the interconnections between callers from one service provider to another occur in a smooth and efficient fashion. The problem is the incentives of the Incumbent provider are to limit access to their infrastructure and to their customer base. As an economist, I would presume that firms and individuals respond to incentives. Since in this particular market incentives of the ILECS are not aligned in a way that would result in market competition driving innovation and price reductions, and there are physical barriers to entry, some form of government regulation continues to be needed.

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[2] Adam Smith, *An Inquiry Into the Causes and Effects of the Wealth of Nations*, Cannan ed., Methuen, 1904, vol. 1, p. 130.

[3] For a detailed history of the telecommunications industry see Gerald Brock, *The Telecommunications Industry* (Cambridge: Harvard University Press, 1981).

II. Necessity of Retaining Michigan Public Service Commission Authority over Wholesale Market

In particular, the Michigan Public Service Commission (MPSC) must serve as the referee to ensure that the CLECs and ILECS are able to use the network in a way that results in a competitive market for telecommunications in Michigan. Because telecommunications requires interconnections between firms, there is a need for an agency to ensure that the interconnections occur smoothly, especially when there is an incentive for some carriers to create difficulties in the interconnection. While market competition will reduce the necessity of MPSC regulation of the retail market, this competition will not be viable in the absence of regulation of the wholesale market. Quality of service and other issues between wholesalers cannot be addressed through the Consumer Protection Act as some have suggested.

AT&T and Frontier remain the dominant carriers in both the residential and business markets, retaining more than six out of ten residential customers and nearly eight out of ten business customers. There are numerous types of telephone companies beyond the ILECs and CLECS—long distance providers, wireless companies (although AT&T and Frontier/Verizon are dominant in the wireless market as well), and cable companies. All of these companies must be interconnected, so when a person calls someone on another network, that call not only goes through, but also has good quality.

Suppose you are a customer of ACME Phone Company, a CLEC, and your calls must go through an AT&T switch or leased line in order to be completed to an AT&T customer. Because AT&T owns the switch, it could theoretically create a situation where ACME calls don't connect well. After awhile, ACME customers would likely drop ACME as their provider. This is not to say that AT&T would in fact engage in such conduct, but the incentive to do so is certainly present. The same would hold if ACME owned the switch. It would have an incentive to provide good service to its own customers and service of a lesser quality to customers of other providers. In order to keep companies from following inherent incentive to monopolize the retail customer, a regulator is needed to require equal service quality throughout the wholesale market.

Numerous other examples exist where the need for owners of infrastructure to provide access to other producers will require regulation to allow the growth of competition at the retail level. How much can one provider charge another carrier for the use of the particular piece of infrastructure that the first provider owns? Should different types of traffic flowing through the same piece of infrastructure, say a land line to a business, face different charges? What type of equipment can connect to other types of equipment in the state-wide infrastructure? Can different protocols be used to impede communication rather than improve it?

Because the telecommunications network is unavoidably interconnected, if there is to be a competitive retail market, the wholesalers must have a mechanism to resolve disputes in how the infrastructure is to be integrated, including the development of new protocols as the industry moves from analogue, to digital, to internet protocol. This is properly the role of government. In particular, the agency best positioned to resolve these disputes is the MPSC rather than the Federal Communications Commission (FCC).

The MPSC has experience in regulating the Michigan telecommunications industry. It understands the particulars of the Michigan infrastructure and it has intimate knowledge of the development of the industry as it has moved from a regulated monopoly towards a competitive market. The Michigan Telecommunications Act requires the MPSC to resolve disputes within a reasonably short time frame, so action by an ILEC or CLEC that would create a barrier to competition could be resolved before it damaged the market. The FCC is not a body designed to handle disputes that are of local importance. Cases before the FCC may take years before final disposition.

III. Will Wireless Remove Interconnection Problems?

Generally, a market system will manage to eventually overcome barriers to entry. Therefore, it might seem reasonable to believe that transition to wireless communication will remove the need for a government referee to settle interconnection disputes. If AT&T owns the phone line that runs past my house and I am an ACME customer, obviously AT&T needs to provide access to its phone line to ACME in order for wireline competition to develop. This obvious wireline example tends to create the impression that my cell phone, which needs no physical wireline connection, does not need to connect to or depend upon wireline infrastructure. Unfortunately, this is not the case.

Wireless calls travel wirelessly only from the closest tower to the cell phone. But the towers are connected to the same wireline network that wireline phones are connected to. There are some towers that have a powerful line of site microwave antennae, but generally the tower is connected to an underground wired T1 or T3 line. As there becomes more cell traffic, such as videos playing on cell phones, the wireline infrastructure becomes more important not less; and, the need to ensure quality and reliable wireline interconnections increases. Thus, the need for the MPSC to referee interconnections will continue into the foreseeable future.

IV. Maintaining Michigan's Copper Infrastructure

Federal regulations have created an incentive with unintended consequences. Because the regulations reduce requirements to provide access to competitors to new infrastructure, ILECs have an incentive when laying fiber to customers to remove or disable the existing copper lines. If the copper is removed, the CLEC's access to the customer premises is severely limited. This is economically inefficient for two reasons. First, the removal of the copper line creates a physical barrier to entry for the CLECs, thus reducing competition in the retail market. Second, advances in technology have greatly increased the carrying capacity of the copper lines. At this point broadband can be provided at speeds up to 100 Mbps, so the copper infrastructure has significant economic value. Any incentive to remove economically efficient copper infrastructure should be limited by the MPSC.

V. Conclusion

Due to the unique history and interconnected character of the telecommunications industry, the ability of the state to oversee wholesale interactions between carriers is not only compatible with the creation and maintenance of a competitive telecommunications market, but is necessary. The industry was a government regulated monopoly during the development of the basic infrastructure, and the industry requires interconnectivity between property owned by the various providers. The Michigan Public Service Commission is the regulatory authority that is best positioned to monitor the interconnection issues and resolve disputes in a fashion that will lead to a fully competitive telecommunications industry in Michigan.